Internal Revenue Service

memorandum

CC:TL-N-6973-89
Br1:LJFernandez

date: JUL 19 1989

to: District Counsel, Chicago CC:CHI
Attn: Robert A. Bedore

from: Assistant Chief Counsel (Tax Litigation) CC:TL

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subject: [redacted]
(Pre-90 day letter)
Your ref.: TL-N-5772-89

This is in reference to your memorandum dated May 18, 1989, requesting Tax Litigation Advice regarding the matter described below.

ISSUE

Whether certain of taxpayer's contracts to manufacture and deliver [redacted] were entitled to be reported for federal income tax purposes under the completed contract method of accounting based upon the rationale that such contracts are for the manufacture of unique items within the meaning of Treas. Reg. § 1.451-3(b)(1)(ii).[1]/

CONCLUSION

The parameters set forth at page eight of this memorandum should be applied to each of the contracts in issue in order to determine whether the items manufactured under each contract are unique within the meaning of Treas. Reg. § 1.451-3(b)(1)(ii). Based upon the information set forth in taxpayer's amended protest letter dated [redacted], we believe the [redacted] manufactured pursuant to the [redacted] are unique items. As to the remaining contracts, we suggest that said parameters be applied by the Appeals Division and the Examination Division to further developed facts in order to make a definitive determination.

1/ The contracts that are the subject of this memorandum were all entered into prior to February 28, 1986, and thus are not subject to I.R.C. § 460, as amended. Pub. L. No. 99-514, § 804(d)(1) (1986).

With regard to the [redacted], we believe that the revenue agent's threshold determination that the [redacted] process is not building, installation, construction or manufacturing within the meaning of Treas. Reg. § 1.451-3(b)(1)(i) cannot be sustained in litigation.

FACTS

The facts outlined in the following paragraphs were garnered from the revenue agent's report (RAR) dated April 15, 1987, and taxpayer's amended protest letter dated [redacted], (attaching protest dated [redacted]), attached to your May 18, 1989, memorandum.

Taxpayer operates in [redacted] business segments in the United States and internationally, including [redacted], [redacted] and [redacted] products. The [redacted] segment consists of [redacted], [redacted] and [redacted] products, [redacted] components, and services performed mainly under contracts and subcontracts with federal government agencies and [redacted] prime contractors. Standard & Poor's, [redacted].

The contracts in question relate to the [redacted] segment and concern agreements with the Department of [redacted] and commercial users. The deficiencies in issue for taxpayer's [redacted] and [redacted] tax years concern approximately [redacted] contracts that were incomplete in [redacted] with a varying number of projects under each contract. A list of these contracts follows:

1) [redacted]
2)
3)
4)
5)
6)
7)

8) [redacted][2] ([redacted])

9) [redacted][3] ([redacted])

The [redacted][4] ([redacted]) encompasses four projects (Nos. [redacted]) for the manufacture of [redacted] which are "[redacted]" of [redacted]. The projects call for production in amounts varying from [redacted] to [redacted] units. Taxpayer has been producing these types of [redacted] for time spans varying between [redacted] and [redacted] years. The revenue agent has determined that the [redacted] are not unique items because taxpayer has produced a very high number of units over a long period of time and, in the case of project [redacted], can store the fabricated [redacted] for delivery on a demand basis.

The [redacted] encompasses four projects (Nos. [redacted]) for the manufacture of devices that activate the [redacted]. The projects call for production in amounts varying from [redacted] to [redacted] units. Taxpayer has been producing such devices for [redacted] years. The revenue agent has determined, based on the frequency of production over a [redacted] year time span, that the manufacture and sale of [redacted] devices is an ordinary occurrence for taxpayer. Thus, such devices are not unique items.

The [redacted] encompasses two projects (Nos. [redacted]) for [redacted]. This procedure consists of removing the [redacted] through a process known as [redacted], and reloading the [redacted] with [redacted]. The [redacted] projects called for [redacted] and [redacted] replacement in [redacted] and [redacted] units respectively. Taxpayer has been performing this task for [redacted] years with respect to [redacted]. The revenue agent's threshold determination is that the contract does not entail building, installation, construction or manufacturing. Furthermore, the revenue agent argues that [redacted] cannot be considered unique given the relatively short time

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[2]/ The titles of these contracts are taken from the RAR and are not used by taxpayer.

[3]/ See footnote #2.

[4]/ With the exception of the [redacted], neither the RAR nor taxpayer's protest provide a detailed description of the subject matter of the manufacturing processes involved. The protest at General Background (PP. I-2 through 6) provides an overview of the process from procurement to follow on production. However, as to the specific contracts in question, with the noted exception, little detail is provided.

([redacted] days for project [redacted], and [redacted] days for project [redacted]) it takes to [redacted].

The [redacted] concerns one project (No. [redacted]) for the manufacture of [redacted]. Taxpayer has been manufacturing [redacted] for [redacted] years but has never before manufactured [redacted]. The Revenue Agent finds this contract comparable to the "folding chair" example in Treas. Reg. § 1.451-3(b)(1)(ii).

The [redacted] ([redacted]) concerns one project (No. [redacted]) for the manufacture of [redacted] of [redacted]. Taxpayer has been manufacturing this type of [redacted] since [redacted]. Because of the high volume of [redacted] produced under this contract, the revenue agent has determined that the [redacted] are not unique items.

The [redacted] encompasses two projects (Nos. [redacted]) for the manufacture of [redacted] and [redacted], respectively, [redacted]. The revenue agent has compared this contract with taxpayer's other contracts for the production of [redacted] and has determined that this contract is an "assembly line" type, due to large volume. Thus, the [redacted] are not unique.

The [redacted] encompasses six projects (Nos. [redacted]) for the manufacture of [redacted].[5/] The projects call for production in amounts varying from [redacted] to [redacted] units. With the exception of project No. [redacted] which requires production of a type of [redacted] that taxpayer has been making since [redacted], taxpayer has been producing such [redacted] since [redacted]. Taxpayer has provided in its protest a detailed description of the [redacted] manufacturing process in support of its position that the [redacted] are unique items. This description will be drawn upon later in this memorandum. The revenue agent has determined, based upon the numbers of units produced under the projects and a comparison to contracts that the agent believes do call for production of unique items, that the [redacted] are not unique items.

The [redacted] ([redacted]), as that term is used by the revenue agent, encompass a variety of projects for production of [redacted], [redacted], [redacted] etc. (Nos. [redacted]). See RAR P. 372. The revenue agent has compared these projects to projects the agent believes do call for the production of unique items and has concluded that the items produced under these projects are not unique.

[5/] We have adopted taxpayer's terminology. The revenue agent refers to these items as [redacted].

The [redacted] ([redacted]), as that term is used by the revenue agent, encompasses seven contracts (Contracts [redacted]) for the manufacture of a variety of products such as [redacted] etc. See RAR PP. 417-418. The revenue agent has determined that such items are not unique because of the volume produced under each contract and/or the relatively short average manufacturing time.

DISCUSSION

I.R.C. § 451 provides that any item of gross income shall be included in the gross income of a taxpayer for the tax year in which the item is received by such taxpayer unless, under the accounting method used by the taxpayer in computing taxable income, the item is properly accounted for as of a different period.

Treas. Reg. § 1.451-3(a)(1) allows income from a long-term contract, as defined in Treas. Reg. § 1.451-1(b)(1), to be included in gross income in accordance with one of two long-term contract methods or any other method that clearly reflects income. The prescribed long-term methods are: (1) the percentage of completion method as described in Treas. Reg. § 1.451-3(c), and (2) the completed contract method as described in Treas. Reg. § 1.451-3(d).

Treas. Reg. § 1.451-3(b)(1)(i) defines the term "long-term contract" as a building, installation, construction or manufacturing contract that is not completed within the taxable year in which it is entered into. Treas. Reg. § 1.451-3(b)(1)(ii) limits this definition as follows:

> Notwithstanding subdivision (i) of this paragraph, a manufacturing contract is a "long-term contract" within the meaning of this subparagraph only if such contract involves the manufacture of (a) unique items of a type which is not normally carried in the finished goods inventory of the taxpayer or (b) items which normally require more than 12 calendar months to complete (regardless of the duration of the actual contract).[6]/ (emphasis supplied).

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[6]/ This provision, which first appeared in the 1976 version of the regulations, T.D. 7397, 1976-1 C.B. 115, remains virtually unchanged in the current version of the regulations, T.D. 8067, 1986-1 C.B. 218, and the Proposed Treasury Regulations, 51 Fed. Reg. 376 (1986).

The regulation continues with examples of the above-quoted limitation as follows:

> Thus, for example, a contract to manufacture a unit of industrial machinery specifically designed for the needs of a customer and not normally carried in the taxpayer's inventory or a contract to manufacture machinery which will require more than 12 calendar months to complete are long-term contracts within the meaning of this subparagraph; however a contract to manufacture 15,000 folding chairs which take three days each to manufacture is not a long-term contract within the meaning of this subparagraph even though it takes more than 12 calendar months to manufacture all 15,000 chairs and the contract is not completed within the taxable year in which it is entered into.

The regulations provide no further guidance on the meaning of the term "unique items". In the instant case, none of the items in issue take longer than 12 months to manufacture. Consequently, the only remaining issue is whether such items are unique. In analyzing the contracts in issue, the revenue agent, in most instances, appears to have established a continuum based upon the regulation cited above. The continuum has at one pole the unit of custom designed machinery and at the other the 15,000 folding chairs. The revenue agent determined whether any contract was for the manufacture of unique items by estimating where items that are manufactured under such contracts fall on the continuum. In placing such items on the continuum the revenue agent took into account the length of time to manufacture an item, the number of items produced under a contract and the taxpayer's experience in producing such items or similar items.

Although the revenue agent's methodology is altogether reasonable, the definition of the term "unique items" has been somewhat refined since the subject audit took place. In Sierracin v. Commissioner, 90 T.C. 341 (1988), the Tax Court arrived at a two-pronged inquiry in determining whether items produced under a contract were unique. The two prongs are: (1) The degree to which products manufactured under the contract are designed for the use of a specific customer and (2) the degree to which the contracts are subject to unpredictable risks that make it difficult to account for ultimate profit or loss on an interim basis.[7]/ The court applied this test to certain contracts of

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[7]/ In Schloegl v. Commissioner, T.C. Memo. 1986-440, the Tax Court concluded that a contract requiring the manufacture of 4,000 steel brackets was not a long-term contract within the meaning of Treas. Reg. § 1.451-3(b)(1). The opinion appears to suggest that a multi-unit manufacturing contract is considered to

three of Sierracin's manufacturing Divisions and found that the products manufactured under the contracts of two of the divisions were unique items.

Sierracin's Sylmar Division produced aircraft transparencies. The court found that the Sylmar products met the first prong of the Sierracin test because each transparency was limited in use to a specific opening in a particular model of aircraft. The court found that the Sylmar contracts met the second prong of the Sierracin test because the manufacturing processes were disrupted at unpredictable intervals by: (a) Difficulty in obtaining quality materials, (b) unforeseen chemical reactions of the finished materials that comprise the transparencies, (c) difficulty in moving from the development phase to the production phase and (d) post-development design changes.

Sierracin's Transtech Division produced impact resistant glazings. The court found that the Transtech products met the first prong of the Sierracin test because each glazing could only be installed in a specific opening in a specific building. The court found that the Transtech contracts met the second prong of the Sierracin test because the manufacturing process is disrupted at unpredictable intervals by: (a) Difficulty in obtaining quality urethane and other materials, (b) nonautomated nature of the production process and (c) dependence upon the accuracy of the glazing contractor's estimate.

Sierracin's Magnedyne Division produced radar related electric motors and tachometers. The court found that the Magnedyne products met the first prong of the Sierracin test because many of the products were "one of a kind", not suitable for functions or customers other than those for which they were designed. However, the court found that the Magnedyne contracts in issue did not meet the second prong of the Sierracin test because: (a) Many of the design variants were only nominally unique in that the products shared a basic design for many customers over a period of years, (b) long experience in the production of the basic design led Magnedyne to expect costs to average out over a given contract and (c) no difficulty in estimating overall contract costs.

In TAM [redacted], (June 30, 1989), Counsel embellished the Sierracin test and drew a distinction between

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(footnote continued)
be a long-term contract only if the manufacturing process requires more than 12 months to produce each individual unit. Schloegl, 52 TCM (CCH) 487, 489. This reasoning would appear to have been refuted in Sierracin. Consequently, Schloegl is of little value in assessing whether an item is unique.

unique items and shelf items. The position taken in the TAM reflects a recent policy decision as to the unique items issue made by the Office of Chief Counsel and the Tax Legislative Counsel, Office of the General Counsel. The TAM provides that a determination of whether a taxpayer's contracts are for unique or shelf items turns on the nature of the item and manufacturing operation by which it is produced. Therefore, an analysis of an item's characteristics as well as those of the manufacturing operation is required, with no single characteristic being determinative. The TAM states that the following characteristics generally distinguish unique items from shelf items. However, because no single characteristic is determinative, an item may be unique even if it lacks one or more of such characteristics.

1. Items that are custom designed to fulfill the particular needs of a buyer are usually unique items. In contrast, items that would be of use to a number of potential buyers and that share a basic design with items that, at the time the contract is entered into, have been produced previously by the taxpayer, generally are shelf items. Items that have these characteristics may be shelf items even if they are manufactured to the particular specifications of a buyer if such specifications do not involve the basic design of the items but instead, for example, involve their size and weight.

2. Performance of a contract to produce unique items often requires the taxpayer to design the items, or to develop the production process, or both, prior to the beginning or during the actual production of the items. Therefore, performance of a contract to produce unique items often requires extensive research, development, design, engineering, retooling, or similar activities. Such activities are extensive if costs incurred or time required to perform these activities are significant compared to the total costs or time to perform the contract. A contract to produce a shelf item does not require extensive research, development, design, or retooling, even though minor or routine redesign or retooling may be necessary.

3. A unique item is generally produced in a nonautomated manufacturing operation or in a specialized manufacturing operation that must be developed or extensively modified in order to perform the contract. An automated, standardized manufacturing operation that has already been developed at the time the contract is entered into generally produces shelf items, even if the items are produced to a buyer's specifications.

4. If the production period of an item is relatively long, it is more likely to be a unique item. On the other hand, if the production period is relatively short, it is more likely to be a shelf item.

The TAM also recognized that unpredictable risk is often associated with the above four factors to the extent such factors result in difficulty in estimating total contract costs at the time the contract is entered into. Nevertheless, the presence of risk is only one indication that an item is unique, and is not required for a finding of uniqueness.

The TAM applied the above characteristics to four contracts for the production of approximately seven million [redacted] and one contract for the production of [redacted] and concluded that such items are not unique within the meaning of Treas. Reg. § 1.451-3(b)(1)(ii). The TAM reasoned that while each customer required the items to be produced to his own specifications, the changes made to the manufacturing processes to comply with such specifications were insignificant because such specifications involved weight and size of the finished product and not the product's basic design. Each contract required the taxpayer to return to the basic design with minor modifications. The taxpayer, because of its established experience with the basic design, thus had little difficulty in estimating overall contract costs.

The revenue agent's report in the instant case does not provide sufficient information to apply the test described above in any meaningful manner. Although some information is provided as to the numbers of units produced under the various projects, the length of time to completion and taxpayer's experience in producing such unit, little information is provided as to the manufacturing processes, the degree of taxpayer design and engineering efforts, difficulty in obtaining raw materials etc. We therefore believe it would be appropriate for you to advise the Appeals and Examination Divisions of the parameters discussed above so that they may make a determination after gathering more information. However, we believe that sufficient information is contained in taxpayer's protest letter, assuming such information is accurate, to allow an analysis of the items produced under the [redacted]. On balance, we believe that such items are unique within the meaning of Treas. Reg. § 1.451-3(b)(1)(ii). Our reasoning may be summarized as follows: First, the [redacted] produced under the contract are custom designed to fulfill the particular needs of the buyer. A [redacted] designed for one application cannot be used for another and even those [redacted] of the same basic design are custom made for different applications and are not interchangeable, e.g., compare the specifications for the [redacted] with those of the [redacted] at protest [redacted].

Second, although the [redacted] is for follow-on production,[8]/ the design of a [redacted] does not remain static. Rather, the design changes throughout the life of a [redacted] program. Thus, a [redacted] manufactured in the later stages of a particular program may be fundamentally different from one produced during the DDT&E stage or under earlier follow-on production contracts.

Finally, the manufacturing operation is complex and hazardous and does not lend itself to an automated, standardized routine. Each [redacted] requires customized [redacted], [redacted], [redacted], [redacted] and other components that in turn require custom tooling by specially trained personnel. Many of the raw materials used in production are available from a single source, and no inventory of raw materials is kept by taxpayer. Preparation of the [redacted] and [redacted] is an arduous, specialized process requiring customized attention. See Protest at [redacted]. Consequently, we believe the [redacted] would be found to be unique under both the Sierracin test as well as the test developed by Counsel as set forth in the [redacted] TAM.

As noted above, we do not believe that enough information has been provided in order to make a determination as to the products manufactured under every contract. However, with regard to the [redacted] we wish to address a final point. As to this contract, the revenue agent has determined that the [redacted] of [redacted] and the reloading of [redacted] is not an activity that would qualify for the long-term contract methods of accounting, i.e., such process cannot be considered to be manufacturing. We do not believe that such position would be sustained by a court.

The word "manufacture" as signifying production, a process or operation, has been defined as the production of articles for use from raw or prepared materials by giving these materials new forms, qualities, properties or combinations whether by hand labor or machinery. Manufacture is also defined as the application of labor to material whereby the original article or material is changed to a new, different and useful article, provided the process is of a kind popularly regarded as manufacture. 55 C.J.S. Manufactures § 1. The term "manufacture"

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[8]/ That is, the contract involves the production of additional hardware for field use and testing using production methods established during the design, development, test and evaluation stage (DDT&E).

has been held to be interchangeable or synonymous with "fabricate," "make" and "process" and it has been held almost synonymous with "produce." (emphasis supplied). Id.[9]/

In Rev. Rul. 79-339, 1979-2 C.B. 218, the Service concluded that the transformation of surplus vessels, wrecked automobiles and other scrap materials into more readily marketable scrap materials constituted "production" for purposes of Treas. Reg. § 1.471-11 concerning the full absorption method of inventory costing. Likewise, concerning Situation 4 in Rev. Rul. 81-272, 1981-2 C.B. 116, the Service concluded that the mere assembly of individual parts of dolls was "production" because such assembly added utility to the product. Thus, to conclude that the [redacted] and removal of [redacted] and the reloading of [redacted], which would essentially salvage and give renewed utility to a [redacted], would appear to be inconsistent with Service position in analogous areas of the federal tax law.

Our conclusion concerning the scope of the term "manufacturing" is also consistent with case law. For example, in Hartley v. United States, 252 F.2d 262 (5th Cir. 1958), the court held that the operations of a taxpayer who engaged in the business of rebuilding automobile engines from salvaged parts and from newly manufactured parts constituted "manufacturing" within the meaning of a statute imposing a tax on the sale and manufacture of automobile parts. See, also, Spalding v. Commissioner, 66 T.C. 1017 (1976), nonacq., 1978-2 C.B. 4 [10]/ in which the Tax Court held that petitioner's operation consisting of dismantling vehicles, (including motor, carburetor and transmission) cleaning same and storing usable parts for resale constituted "manufacturing" or "production" for purposes of the investment tax credit.

Based on the above, we conclude that items produced under the [redacted] are unique items within the meaning of Treas. Reg. § 1.451-3(b)(1)(ii). We recommend that the unique items test outlined above be applied to developed facts in order

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[9]/ See also, Seago Planning Still Available When Dealing With Long-Term Contracts, 71 Journal of Taxation No. 1 (July 1989); What Constitutes Manufacturing and Who Is A Manufacturer Under Tax Law, 17 ALR 3d 18.

[10]/ [redacted] AOD-OM 70133 (Nov. 23, 1976), supports the position that [redacted] is "manufacturing" or "production" in its argument that such terms are to be given there ordinary meaning for purposes of ITC, and through its reference to Treas. Reg. § 1.48-1(d)(2). The AOD states, however, that the mere disassembly and cleaning of vehicle parts is not "manufacturing" or "production."

to determine whether items produced under the other contracts are also unique. We also conclude that the government would be unlikely to prevail if it attempted to characterize the process described under the [redacted] writeup as something other than "manufacturing" for purposes of Treas. Reg. § 1.451-3(b)(1)(i).

We note that this memorandum should not be circulated beyond the Office of Chief Counsel. Specifically, a copy should not be made available to the Examination Division. Further, neither taxpayer nor its counsel should receive a copy or even be made aware that Tax Litigation Advice was requested. CCDM (35)8(12)7.

We also note that taxpayer may have a right to request technical advice from the Associate Chief Counsel (Technical) pursuant to the provisions of Rev. Proc. 89-2, 1989-1 I.R.B. 21. Although the conclusion of this memorandum may be read as wholly favorable to taxpayer, we do not wish to compromise taxpayer's rights should the unique items test as applied by the Appeals Division or Examination Division result in an adverse determination.

If you have any questions, please contact Lewis J. Fernandez at (FTS) 566-4189.

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Attachment
TAM Nuclear Metals

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